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The real exchange rate and economic growth: Revisiting the case using external instruments[☆]

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Abstract

We investigate the impact of movements in the real exchange rate on economic growth based on five-year average data for a panel of over 150 countries in the post Bretton Woods period. Unlike previous literature, we use external instruments to deal with possible reverse causality from growth to the real exchange rate. Our country-specific instruments are (i) global capital flows interacted with individual countries' financial openness and (ii) the growth rate of official reserves. We find that a real appreciation (depreciation) reduces (raises) significantly annual real GDP growth, more than in previous estimates in the literature. However, our results confirm this effect only for developing countries and for pegs.

Keywords: Real exchange rate, economic growth, instrumental variables, panel data
JEL: F31, F43

1. Introduction

Exchange rates and the choice of the exchange rate regime retain a centre stage in the post-crisis environment especially for emerging economies (Klein and Shambaugh, 2010; Rose, 2011; Ghosh et al., 2014). In particular, there is a significant divide between policy-makers and economists regarding the impact of foreign exchange policies on growth. Whereas laymen and politicians are often intimately convinced that a lower exchange rate will spur

[☆]The views expressed belong to the authors and are not necessarily shared by the European Central Bank.

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